DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 05-0512
Corporate Income Tax for 2003

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Adjusted Gross Income Tax – Forced Combination

Authority: IC § 6-8.1-5-1(b); IC § 6-3-2-2(*l*); IC § 6-3-2-2(m).

The taxpayer protests the forced combination with its related corporations.

Resolved Issue

The following issue is resolved. It is included in this letter of findings so as to maintain a record.

The computation of the Net Operating Loss deduction for 2001 is accepted. Taxpayer had RARs completed for 1998 and 1999 which changed the NOL being carried. Taxpayer amended the 2000 federal AGI which modified the NOL coming forward. The adjustments are material and the Department needs to make the adjustments.

STATEMENT OF FACTS

Taxpayer owns retail stores that rent and sell electronics, furniture, and appliances, some of which are in Indiana. Taxpayer was audited for the years 2001, 2002, and 2003. Only the 2003 audit is at issue, caused by Taxpayer's corporate restructuring that year. This letter of findings only describes Taxpayer's corporate structure for 2003 because discussions of the previous corporate structure and the present corporate structure are not relevant to the 2003 corporate income tax audit protest.

There is a parent holding company. It has two wholly-owned subsidiaries: Taxpayer and Insurance Division. Discussion of Insurance Division is not relevant to this letter of findings. Taxpayer has two wholly-owned subsidiaries: Royalty Company and Management Company.

Taxpayer is the legal entity for the retail stores in the eastern United States. Royalty Company is the owner of Taxpayer's trademarks and is the legal entity for the retail stores in the western United States. Management Company performs strategic management functions for Taxpayer's stores and manages the retail stores in Texas.

Taxpayer's retail stores in Indiana pay a 3 percent trademark royalty to Royalty Company. Taxpayer's Indiana retail stores are guaranteed a 4.5 percent profit. The remainder of the profits are paid to Management Company for strategic corporate management services. To better understand the arrangements between the related companies is an example of the transactions.

If Taxpayer's Indiana retail store has $1,000 of gross revenues, a 3 percent trademark royalty is paid to Royalty Company. That leaves $970. From that $970, the Indiana retail store has direct expenses. If those direct expenses are $770, that leaves $200 of revenues. The Indiana retail store retains 4.5 percent of the $200 as guaranteed "residual profit" and the remainder is paid to Management Company for strategic corporate management services. In this example, the Indiana retail store would retain $9 of the $200 and $191 would be paid to Management Company. According to Taxpayer, only the $9 would be subject to Indiana corporate income tax as Indiana income.

In the audit, the Department forced a combined corporate income tax return for Taxpayer, Royalty Company, and Management Company, stating that the companies have a unitary relationship. The Department determined that when the three companies report separately, it does not allow Taxpayer, who operates the Indiana stores, to report a fair reflection of its Indiana income. Taxpayer filed combined federal returns and combined state returns in those states with a statutory requirement to do so.

Taxpayer protested the forced combined Indiana return. A hearing was held and this letter of findings is issued.

I. Adjusted Gross Income Tax – Forced Combination of Return

DISCUSSION

All tax assessments are presumed to be accurate; the taxpayer bears the burden of proving that an assessment is incorrect. IC 6-8.1-5-1(b).

IC 6-3-2-2(m) states:

> **In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interest, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.**

IC 6-3-2-2(*l*) vests both taxpayers and the Department with authority to allocate and apportion a taxpayer's income within and among the members of a unitary group of related entities:

> **If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer**

> **may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:**
> **(1) separate accounting;**
> **(2) the exclusion of any one (1) or more of the factors;**
> **(3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or**
> **(4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.**

It is apparent from IC 6-3-2-2(*l*) that the standard apportionment filing method is the preferred method of representing a taxpayer's income derived from Indiana sources. The alternate methods of allocation and apportionment—including the combined reporting method—are only employed when the standard apportionment formula does not fairly reflect the taxpayer's Indiana income.

Taxpayer uses the income it earns in Indiana to pay Royalty Company and Management Company for services provided to Taxpayer. Taxpayer provided the Department a copy of the analysis of profit distribution report prepared for Taxpayer by an independent, third-party consulting firm. The report outlines the appropriate compensations that should be paid and received for trademark services and management services. The report acknowledges that the services are intercompany transactions. The report conducted an analysis of the market and "broadly comparable" retailers in determining the value of the services; nineteen were compared. From this, the consulting firm priced the fair-market value of the trademark and management services. The true value of these services is best determined by the actual costs. A combined, unitary Indiana corporate income tax return best reflects those costs; this is the situation foreseen and outlined in IC 6-3-2-2 (*l*) and (m). Actual costs are better than extrapolated costs; a combined, unitary Indiana return will fairly reflect the income derived from Indiana sources and the actual expenses and deductions.

FINDING

Taxpayer's protest is respectfully denied.

AG/JM/DK 060607